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CIO Viewpoint

Ventilating economies with intensive care

Investment Solutions

19 May 2020

The deepest recessionary shock in at least 80 years has disrupted nearly every aspect of our lives and triggered an unprecedented response from policy makers. Like doctors ventilating a severe Covid-19 patient, investors are asking whether these massive central bank injections into economies will create a healthy level of inflation.

The question looks urgent. The weakness of aggregate demand and oversupply means the economic effects of the virus are, for now, disinflationary. The speed that demand recovers versus supply holds the key to the path of inflation, which in turn determines the path of interest rates and asset returns. We believe that the Covid-19 crisis will accelerate or exacerbate trends that were already under way, including a slow return to a lengthier period of sluggish inflation.

Until most of the world locked-down, economies globally were suffering from low growth with very low inflation and commodity prices. Post-pandemic, economic recoveries are going to be uneven, with some supply-side activity bouncing back quickly while demand remains depressed, creating a build-up in inventories. That suggests that even after an initial wave of recovery, the economy will be operating below pre-virus output levels, perhaps at least until late 2021.

Rather than countering a market imbalance or providing excess liquidity, central banks' monetary responses to the pandemic and its lockdowns are compensating for the evaporation of the usual commercial bank loans and financial market credit and equity sources.

To forecast inflation we focus on three elements: the monetary phenomenon, energy prices and economic growth. Inflation is a monetary reaction to more money in circulation and not enough to buy. With the collapse in demand for oil, energy prices also look an unlikely source of inflation, and economic activity will remain disrupted for some time.

A slow recovery in inflation therefore looks most likely. Even as we lift containment measures, some of the jobs lost in the last two months will prove permanent. Not all retailers, restaurants, airlines or hotels will survive. That will force large parts of the population to limit spending and create a strong deflationary pressure on economies. We do not believe that in this environment we will see either demand for higher wages, nor rising prices. At the same time, these labour market pressures should offset changes to supply chains that some economists argue will give a stronger push to economies and higher inflation.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- Depressed demand and oversupply make the economic effects of Covid-19 disinflationary for now
- We expect an uneven economic recovery and believe that the crisis exacerbates existing trends, including a lengthier period of sluggish inflation
- Central banks should have a year, or more, to maintain stimulus without triggering excessive inflation
- A lack of catalysts to reprice inflation expectations, plus negative real yields, may keep inflation-linked bonds undervalued for the months ahead.

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Worse, longer

With the collapse in demand for petroleum, we estimate that inflation will not return to early 2020 levels for at least 12 months in the US and eurozone, even with oil at USD50 per barrel (see charts). That suggests central banks have another year, or more, to keep their stimulus measures in place without triggering excessive inflation.

Last week's comments from Jerome Powell, Chairman of the US Federal Reserve (Fed), support this outlook. The US may face an "extended period of low productivity growth and stagnant incomes," he said. Congress has responded with economic programmes totalling USD3 trillion.

That may not be enough. "Additional fiscal support could be costly but worth it," Mr Powell added, before promising that, "when this crisis is behind us, we will put these emergency tools away." In the wake of the 2008 financial crisis, central banks halted their asset purchase programmes. That did not create an inflationary environment.

Debt and taxes

Still, economics, especially when it affects public spending and taxes, is also about politics. Governments will be reluctant to see independent central banks withdraw monetary support. No democratic government will want to risk votes by returning to austerity policies, including high taxes to pay off public debt. That would undermine already precarious incomes, widen inequalities again and further challenge stretched health networks.

What does this persistently weak growth, low-inflation environment mean for portfolios? Some investors may see inflation-linked bonds as an apparently logical response. Inflation-linked bonds can be used to hedge against rising inflation that would otherwise undercut sovereign bonds' real returns. The cash flows paid by these instruments are indexed to consumer prices and rise in times of high, realised inflation, protecting investors against a fall in purchasing power. We can infer market expectations of future inflation by comparing the nominal yield of traditional bonds to the real yield of inflation-linked bonds. In reaction to the pandemic, inflation expectations have fallen sharply with 10-year inflation break-even rates dropping around 70 basis points on both sides of the Atlantic to 1.05% in the US and 0.40% in Germany, at the time of writing.

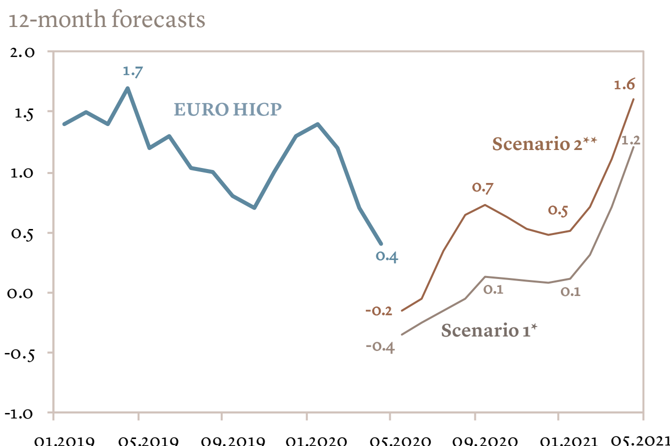
These are historically low levels, even compared with the Great Financial Crisis. However, while inflation-linked securities look attractive versus nominal bonds from a relative valuation point of view, the lack of short-term catalysts to reprice inflation expectations, combined with the current negative real yields, may keep the asset class undervalued for the months ahead.

Negative real rates support economies in times of crisis by encouraging investment and consumption. Expectations of low inflation cannot lead to sufficiently negative real rates, and so economies depend on policymakers pushing nominal rates deeper into negative territory to achieve these levels of negative real rates.

Faced with stubbornly low inflation expectations, the central banks of Japan, Switzerland and the eurozone had no alternative policy in the wake of the great financial crisis, and continue to endorse them today. In contrast, inflation expectations in the US and UK have been sufficient to push real rates below zero without the need for negative nominal yields, and so avoid hurting American and British commercial banks. The Fed and the Bank of England continue to oppose negative rate policies. Mr Powell has quashed any investor expectations of negative rates. "I continue to think," Mr Powell said in a 17 May interview, "that negative interest rates is probably not an appropriate or useful policy for us here in the United States." But if inflation expectations drop to levels seen in the rest of Western world, negative nominal rates in the US and UK could look like a real possibility.

1. Eurozone HICP (Harmonised Index of Consumer Prices) scenarios with Brent crude

12-month forecasts



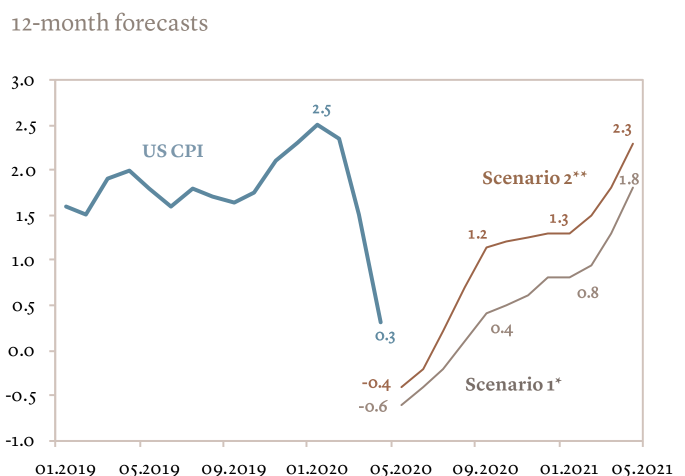
*Scenario 1: Oil at USD 30 and remains at USD 30
Core inflation evolves from 0.8% to 1.1%

** Scenario 2: Oil reaches USD 50 in three months and remains at USD 50
Core inflation rises from 0.8% to 1.1%

Sources: Eurostat, Lombard Odier calculations

2. US CPI scenarios with Brent crude

12-month forecasts



*Scenario 1: Oil at USD 30 and remains at USD 30
Core inflation evolves from 0.8% to 1.1%

** Scenario 2: Oil reaches USD 50 in three months and remains at USD 50
Core inflation rises from 1% to 1.2%

Sources: US Bureau of Labor Statistics, Lombard Odier calculations

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